

COMMISSIONER'S DECISION ON RECONSIDERATION
OF THE NOVEMBER 27, 2006
POINT THOMSON UNIT TERMINATION DECISION

December 27, 2006

Findings and Decision of the Commissioner
Department of Natural Resources
State of Alaska

I. SUMMARY OF DECISION.

This is the final Decision of the Alaska Department of Natural Resources on the request of the Point Thomson Unit (PTU) lessees (Lessees) for reconsideration of the November 27, 2006 Commissioner's decision terminating the PTU (Commissioner's Decision). DNR appeal regulations do not provide for reconsideration of a Commissioner's final decision on an appeal from a decision of the DNR Director of Oil and Gas. In this case, however, I find it appropriate to issue a decision on the points raised in the request for reconsideration.

Lessees have requested the following substantive relief: (1) reversal of the finding that PTU contains no wells certified as capable of producing in paying quantities on the grounds that (a) the finding is inconsistent with a long established DNR policy to certify exploration wells and wells that have been plugged and abandoned; (b) it creates uncertainty about the status of other oil and gas units and leases; and (c) lessees of state oil and gas leases have relied on the DNR well certifications; and (2) reversal of the decision to terminate the unit on the ground that the unit contains certified wells, and therefore, the unit can only be terminated through judicial proceedings.

Lessees have also requested that DNR reopen the administrative proceedings. They claim that they did not receive fair notice that the certified well status of PTU wells was at issue.

Lessees also contend that DNR refused to allow them to review DNR files.

I find no merit in the points raised in the Request for Reconsideration.

Lessees had notice of the certified well issue. ExxonMobil argued the issue in its appeal papers as did the Port authority. The request to reopen the DNR administrative proceedings is denied.

Lessees do not on reconsideration challenge the grounds for unit termination stated in the Commissioner's Decision: unwillingness to commit to put the unit into production and failure to submit an appropriate Plan of Development (POD). Instead, the focus of reconsideration is the collateral finding that the PTU does not contain wells certified as capable of producing in paying quantities.

Lessees assert that if the PTU has certified wells, the Commissioner's Decision was inappropriate because the unit can only be terminated through judicial proceedings. Lessees' argument is based on a regulation. But Lessees ignore other regulations which provide for the DNR Commissioner to make unit default and related findings regardless of whether the unit contains certified wells.

Lessees also contend that DNR is estopped from revoking the certification of PTU wells as capable of producing in paying quantities. Lessees say they have relied on a long standing DNR policy of certifying wells after they have been plugged and abandoned and of certifying wells which were not production facilities to hold state oil and gas leases beyond their primary term. Lessees contend that the certified well finding is bad policy because it will generate uncertainty in the oil and gas industry. The finding suggests that many state oil and gas leases outside of the PTU will no longer be held by certified wells that were plugged and abandoned.

The Commissioner's Decision regarded the Point Thomson Unit. It did not directly regard leases, and it did not address any other unit. Certification of a well that does not exist as capable of producing in paying quantities is poor policy. DNR does not need to certify a non-existent well in order to extend

the term of a lease. There are other much more appropriate ways to extend the term of a lease. The other leases and units that Lessees are concerned about will be administered based on the facts applicable to them, and not the facts applicable to the PTU. Therefore, Lessees' argument that DNR is estopped from issuing the Commissioner's Decision is not accepted.

Lessees' contention that DNR violated the Covenant of Good Faith and Fair Dealing by terminating the unit when DNR had participated in negotiations for a gas pipeline contract is without merit. The contract was never approved. The Director's October 27, 2005 decision put Lessees on notice that they were not entitled to keep the PTU out of production until a gas line was built.

DNR did not deny Lessees access to its files. DNR asked Lessees to submit their document request in writing.

I affirm the Commissioner's Decision in all respects.

II. DNR File Records Request.

Lessees assert that DNR has denied them access to DNR files. On the afternoon of Thursday, September 14, 2006 an ExxonMobil representative contacted DNR and requested to review 105 files on Friday morning. On Friday, September 15, 2006 DNR sent ExxonMobil a letter by facsimile and mail asking ExxonMobil to put its document request in writing. Lessees have not responded to DNR's letter. Lessees' assertion is not supported by the facts.

III. The Requests for Reconsideration Do Not Challenge the Basis of the November 27, 2006 Unit Termination Decision.

The certified well finding is not the basis of the November 27, 2006 unit termination decision. The unit termination decision

is based primarily on two independent grounds neither one of which regards certified wells.

One ground for unit termination is that DNR is entitled to terminate a unit which has been known to contain massive hydrocarbon reserves for more than 30 years, but which has never been put into production, when the lessees of the state oil and gas leases making up the unit unequivocally state that they still cannot find a way to put the unit into production. DNR is entitled to terminate the unit because the purpose of forming a unit is to effect production. Units are not formed for the purpose of simply holding properties until such time as the Lessees think production will be profitable enough to commence. On these facts, when the Lessees say they cannot put the unit into production, DNR can terminate the unit as a matter of law.

The second primary ground for unit termination is the failure to submit an acceptable Plan of Development. The Director's October 27, 2005 Decision put the Lessees on notice that the 22nd POD was unacceptable, and that it failed to meet the requirements of the unit agreement and the regulations. Lessees had nearly a year to cure by submitting an acceptable Plan of Development that committed to put the unit into production. Instead they submitted a revised 22nd POD which suffered from the same defects as the original 22nd POD. As discussed in the Director's Decision, these PODs did not meet the requirements for an acceptable POD set out in the unit agreement or the regulations.

There are other facts relevant to the unit termination decision such as the Lessees' statements that the PTU will never be produced until there is a gas pipeline notwithstanding the fact that the PTU is among the largest oil reserves on the North Slope, and it also contains hundreds of millions of barrels of gas condensate. Neither the oil nor the gas condensate require a gas pipeline to produce. Lessees' statements that more tax and royalty concessions will be needed before

production can occur and refusal to drill exploratory wells to further delineate the unit, also provide grounds for unit termination, but the primary basis of the decision is the unequivocal statement that the Lessees cannot find a way to put the unit into production and their refusal to submit an acceptable POD.

Therefore, the issue of whether the PTU contains certified wells is separate from whether the unit should be terminated. The Requests for Reconsideration do not challenge the basis for the unit termination decision.

IV. Lessees Incorrectly Conclude that if The PTU Contains Certified Wells, DNR Could Not Issue a Unit Termination Decision.

Lessees contend that if the PTU contains certified wells then DNR does not have the power to issue a decision terminating the unit. This argument is based on a unit regulation 11 AAC 83.374(d) which provides:

“If a default occurs with respect to a unit in which there is a well capable of producing oil or gas in paying quantities and the default is not cured by the date indicated in the demand, the commissioner, will in his discretion, seek to terminate the unit agreement by judicial proceedings.”

According to ExxonMobil, this regulation means that if a unit contains a certified well, DNR is without the power to issue a unit termination decision. This position is not supported by the regulations.

Unit regulation 11 AAC 83.374 sets out DNR remedies in the event of unit default. Subsections (a) and (b) apply to all units, subsection (c) applies to units without certified wells and subsection (d) applies to units with certified wells. Subsection (a) provides that failure to comply with the terms of the unit agreement is default, and subsection (b) provides that

DNR will give notice of the default and at least 90 days to cure. Subsection (c) provides that where the unit does not contain a well capable of producing in paying quantities, the DNR Commissioner may terminate the unit effective upon mailing the notice of termination. Subsection (d) provides that where the unit does contain a well capable of producing in paying quantities, the Commissioner will seek to terminate the unit agreement by judicial proceedings.

Regardless of whether the unit contains certified wells, the regulations anticipate that DNR will issue appropriate notices and that DNR will give an appropriate opportunity to cure. In his November 27, 2006 Decision, Commissioner Menge affirmed the notice of default and conditions for cure set out in the October 27, 2006 decision, the unacceptability of the cure offered by Lessees on October 18, 2006, and the consequences thereof: unit termination.

Regardless of whether the unit contains certified wells, it was incumbent on the DNR Commissioner to decide these issues. Even if the PTU contains certified wells, the November 27, 2006 Decision is an appropriate DNR action which facilitates court review.

V. Lessees' Request that DNR Continue the Fiction of Certifying Non-Existent Wells as Capable of Producing in Paying Quantities.

Lessees assert that the certified well finding will have a chilling effect on oil and gas development in Alaska because many leases and units are held by certified wells, and the Commissioner's Decision puts them in jeopardy. Lessees contend that the November 27, 2006 Decision contradicts longstanding DNR policy to certify wells that have been plugged and abandoned.

With regard to long standing DNR policy, it is true that DNR Directors of Oil and Gas have certified wells after they have

been plugged and abandoned and that they have also certified wells that were not production wells. But this is the first time the question has been addressed by a DNR Commissioner.

Commissioner Menge disapproved the Director's Decision to the extent that it could be read to mean the PTU contains certified wells. He also found that the PTU contained no certified wells because all the wells that had been certified were exploration wells, and they had all been plugged and abandoned. That finding conforms the status of the wells to the facts.

Regarding the assertion that the November 27, 2006 Decision jeopardizes other units and leases, the Commissioner's Decision is not that broad. It was about the continued existence of the PTU. It did not address any other unit, and it did not directly address any leases, PTU or otherwise.

Lessees contend that they have been relying on the well certification as a method of, in effect, extending lease terms all over Alaska. Now they say that all these leases will terminate because of the Commissioner's Decision. But certification of a well does not extend the lease term, and there are other methods DNR could use to extend the term of a lease or unit. It is not necessary to certify a non-existent well to hold a lease or unit. Other units and all leases will be addressed in their own proceedings, on their own facts, and in the normal course of business. The November 27, 2006 Commissioner's Decision does not directly affect those units or leases, and it does not mean that they will necessarily terminate even if they have an abandoned well that was certified.

VI. Lessees Do Not Directly Challenge the Basis for the Certified Well Finding.

PTU Lessees do not directly challenge any of the certified well findings of the Commissioner's Decision, any one of which support the finding that there are no PTU certified wells. For

instance, PTU Lessees do not contest the following findings: (1) the wells which were certified were not in fact production wells; and (2) the wells which were certified have all been plugged and abandoned.

The Lessees argue that the Commissioner's Decision reverses longstanding DNR Director's Decisions certifying plugged and abandoned wells. This fact is not contested by DNR. But the DNR Commissioner has the ultimate authority to set DNR policy, this is the first time the issue has reached the level of the DNR Commissioner, and the Commissioner has the responsibility to correct poor policy. Certification of a non-existent well is poor policy not just because the well cannot be ordered into production but because it sends the wrong message to state oil and gas lessees. According to the papers filed by Lessees on reconsideration, they interpret the certification of a well as an indefinite extension of the lease upon which it was drilled. This is not an appropriate policy. The agreements, regulations and statutes provide for lease extension where a lessee makes appropriate commitment to explore, produce or otherwise develop oil and gas leases.

VII. Exxon Was on Notice of the Certified Well Issue and Addressed it in its filings of November 3, 2006.

Lessees contend that the issue of certified wells was raised for the first time in the November 27, 2006 Commissioner's Decision. They assert that they did not have fair notice of the issue, and they request that the administrative proceedings be reopened so that they can address this issue. The record indicates that Lessees were on notice of the certified well issue.

Certified Wells were addressed in the ExxonMobil appeal papers. ExxonMobil contended that DNR was without the power to decide to terminate the unit because the unit contained certified wells. ExxonMobil contended that a unit termination decision could only be made by a court because the unit contained certified wells. ExxonMobil also relied on a

statement in the Director's October 27, 2005 decision that the PTU contained certified wells.

The Port Authority also addressed the certified well issue in its appeal papers. The Port contended that the PTU contained no certified wells. Lessees received a copy of the Port Authority Appeal papers.

PTU Lessees made no request for the provision of appeal procedures that was denied. PTU Lessees chose not to address the certified well issue at the hearing held November 20, 2006.

It would be inappropriate to reopen the proceedings on an issue of which PTU Lessees had notice but chose not to address. Also, PTU Lessees have addressed the certified well issue in their 2,000 plus pages of filings on reconsideration.

These filings show that the Lessees' focus is that the certified well finding reverses longstanding DNR Oil and Gas Director's Decisions that certify non-existent or non-production wells. This is not disputed.

Lessees go on to assert the reversal is bad policy and that it will work against development of Alaska oil and gas resources. Lessees say they relied on the Director's certified well decisions to their detriment because the decision subjects them to loss of oil and gas leases and other units which they considered to be held by certified wells. The focus of this proceeding and the Commissioner's Decision is the PTU, not any other unit or any lease. There are appropriate ways to hold a lease or unit. Certification of a non-existent well is not one of them. Lessees can raise any argument they deem appropriate in connection with the other units and any leases they are concerned about in the normal course of business. Those leases and units are not a basis to reopen the record here.

Commissioner Menge decided that a well that has been plugged and abandoned does not qualify to be treated as a well certified as capable of producing in paying quantities. I agree. The longstanding policy upon which the Lessees say they relied was the poor policy. The new policy is in conformance with existing statutes, regulations and agreements. Certified wells will still play a role in appropriate circumstances. Finally, Lessees will have the opportunity to address the issue should they choose to appeal to the Superior Court.

VIII. Estoppel.

Lessees contend that DNR is estopped from revoking the certifications of seven PTU wells because the Lessees have relied on the DNR policy of certifying non-existent wells all over Alaska to Lessees' detriment. Again, the issue before the Commissioner in the November 27, 2006 Decision was the continued existence of the PTU, and not another unit or any leases.¹ Therefore, it is inappropriate to treat the Commissioner's Decision as having the broad impact Lessees ascribe to it.

As previously stated, DNR has other mechanisms for extending the terms of units and leases. Certification of a non-existent well is not the proper way to extend a lease.

Regarding detrimental reliance, all who hold leases with wells certified by DNR have had the benefit of that certification. In some cases this had allowed leases to be held for decades with no production and no meaningful plan of development.

The import of the November 27, 2006 Decision is not that Lessees are going to lose units and leases all over the state, it is that leases and units should not be considered to be held by non-existent certified wells. Leases will need to be held by

¹ The exception to this is the decision on the Expansion Agreement which regards the PTU expansion leases. That matter is not on reconsideration.

an appropriate commitment to explore, develop, produce or some other basis consistent with the state's interest, and they will not be held based on a fictional certification of a non-existent well.

Lessees' theory appears to be that once certified, a well holds a lease forever. This is not consistent with the statutes, regulations, applicable agreements, or meaning of certified well. Estoppel does not apply in this case to require a change to the November 27, 2006 Commissioner's Decision.

IX. Covenant of Good Faith and Fair Dealing.

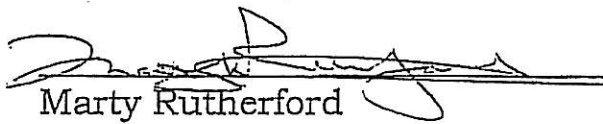
Lessees contend that DNR breached the Covenant of Good Faith and Fair Dealing because Lessees negotiated a contract with the state for construction of a gas pipeline, and the 22nd PTU POD merely proposed developing the PTU in accordance with the contract. This argument fails because the gas line contract was never approved. It also fails because Lessees were on notice during the gas contract negotiations that DNR considered the PTU to be in default for failure to commit to production and failure to submit an acceptable plan of development. Lessees were given a year to cure by submitting an acceptable plan. The Director's decision unequivocally rejected Lessees' position that the PTU could not be produced until there was a gas line. Lessees' contentions regarding the Covenant of Good Faith and Fair Dealing are not supported by the facts – there was no contract and Lessees were noticed that they could not condition development on a gas line.

X. Decision.

The Commissioner's Decision is affirmed in all respects.

The Lessees' request to reopen the DNR administrative proceedings is denied.

This is the final administrative order and decision of the department for purposes of an appeal to Superior Court. An appellant affected by this final order and decision may appeal to Superior Court within 30 days in accordance with the rules of the court, and to the extent permitted by applicable law.



Marty Rutherford
Acting Commissioner
Alaska Department of Natural Resources

12-27-2006

Date

cc: Michael Menge,
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